Internal Revenue Service

memorandum

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from: Senior Technical Reviewer, CC:INTL:Br5
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subject: [redacted]

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This is in response to your inquiry as to whether the residual securities allocation rule (also known as the 10 percent rule) in § 1.864-4(c)(5)(ii)(b)(3) requires that total third party assets of the U.S. branch include interbranch assets and\or non-effectively connected assets.

BACKGROUND

Under § 1.864-4(c)(5)(ii), U.S. source income, gain or loss from stocks or securities attributable to a U.S. office of a banking, financing or similar business are generally treated as effectively connected ("ECI") for such year with the conduct of that business. For purposes of subparagraph (c)(5)(ii), securities are basically defined as debt

instruments, rights in, or rights to subscribe to or purchase a debt instrument. § 1.864-4(c)(5)(v). Whether a U.S. source security is attributable to a U.S. banking, financing or similar business is determined by whether the U.S. office "actively and materially participated in negotiation, solicitation or performing other activities required to arrange the acquisition of the stock or security." § 1. 864-4(c)(5)(iii)(a). See Rev. Rul. 86-154, 1986-2 C.B. 103. This material participation test applies only to banking, financing or similar businesses, notwithstanding the general asset use and business activities tests of § 1.864-4(c)(2) and (3). The material participation test also applies for determining whether foreign source securities are attributable to a U.S. office. § 1.864-6(b)(ii). See Rev. Rul. 75-253, 1975-1 C.B. 203.[1]

If income from stocks or securities is not "attributable" to a U.S. office of a banking, financing or similar business under the active and material participation test, it is treated as 100% non-ECI and will be subject to tax under sections 871, 881, 1441, 1442 (subject to any treaty benefits available by application of Section 894). If the income, gain or loss is attributable, it is treated as 100% ECI unless the class of stocks or securities giving rise to the income, gain or loss is not specifically described in § 1.864-4(c)(5)(ii)(a)(1) through (3) or (ii)(b)(1) or (2).[2] Stocks

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[1]The ruling held that "a foreign corporation cannot...avoid the taxation of effectively connected foreign source income simply by holding securities outside the United States."

[2] The classes of securities "attributable" to a U.S. office that give rise to 100% ECI under 1.864-4(c)(5)ii) are stocks or securities that:

(a) were acquired

(1) As a result of, or in the course of making loans to the public;

(2) In the course of distributing such stocks or securities to the public, or

(3) For the purpose of being used to satisfy the reserve requirements, or other requirements similar to reserve requirements, established by a duly constituted banking authority in the United States, or

(b) Consist of securities (defined as "any bill, note, bond,

or securities not specifically described in subparagraph (ii) are classified as belonging to a residual or default class which encompasses all other stocks or securities. § 1.864-4(c)(5)(ii)(b)(3). Income from this residual class "not described" is treated as ECI under a formula allocation rule, otherwise known as "the 10% rule."[1]

Under the 10% rule, the average book balance of the residual class securities is measured against the total book value of the assets of the U.S. office to determine whether the income, gain or loss from the residual class should be allocated out of ECI status and treated as noneffectively connected income, gain or loss. This determination is made by the following allocation formula:

$$10\% / \frac{\text{Average Residual Class - "(b)(3) Securities"}}{\text{Total Average Assets of U.S. Office}}$$

For example, if average (b)(3) securities are $1 billion and average total assets of the U.S. office are $2 billion, the denominator or devisor ratio is 50%. Then, 10% divided by 50% = 20%. This means that 20% of the income, gain or loss from (b)(3) securities is treated as ECI (even though it was initially attributable to the U.S. office, i.e., 100% ECI before the allocation). The remaining 80% recasts as non-ECI. [Note: if the devisor ratio is less than 10%, then 100% of the income, gain or loss from the (b)(3) securities is treated as

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debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items")

(1) Payable on demand or at a fixed maturity date not exceeding 1 year from the date of acquisition, or

(2) Issued by the United States, or any agency or instrumentality thereof.

Stocks or securities classifiable under subparagraph (b)(3) are subject to the 10% rule and as explained, infra, may not give rise to 100% ECI.

[1]In 1996 we clarified in a separate written technical advice concerning this taxpayer that foreign source securities were subject to the classification requirements of Section 1.864-4(c)(5)(ii) by reference over from Section 1.864-6(b)(2)(b), and that residual classification of such securities under Section 1.864-4(c)(5)(ii)(b)(3) could also result. Our advice with respect to that issue remains the same.

ECI. e.g. (b)(3) securities are $1 billion, total securities are $11 billion, i.e. denominator is 9.9%; 10% divided by 9.9% is > 100%, i.e., the cap is 100% ECI.]

In the current case, the taxpayer has applied the 10% rule formula using only average third-party effectively connected assets in the "Total U.S. Assets" portion of the formula. All third-party noneffectively connected and interbranch assets of the U.S. office have been excluded. Such treatment would cause the divisor-ratio to increase which in turn would cause a higher percentage of income from the residual class of securities to be reclassified as noneffectively connected. For example, assume the U.S. office had the following average assets:

Residual Class Securities	$1b
Total Assets of U.S. office including Residual Class	$2b
Effectively Connected Assets including Residual Class	$1.25b
Noneffectively Connected Assets	$0.75b
Interbranch Assets of the U.S. Office	$0.5b

If the noneffectively connected assets are excluded from "total assets of the U.S. office" as used in the 10% rule formula, the divisor ratio rises from 50% [i.e. 1 billion / 2 billion] to 80% [i.e. 1 billion / 1.25 billion]. The amount of effectively connected income from (b)(3) securities would be reduced from 20% [10%/50%] to 12.25 [10%/80%]. Accordingly, the amount of income treated as noneffectively connected would increase from 80% to 87.75%.

In response to the taxpayer's proposed treatment, the field has also inquired whether the divisor ratio might be increased by including average interbranch asset balances in the "Total U.S. Assets of the U.S. Office" portion of the divisor/ratio. For the reasons set forth below, we conclude the following:

(1) The average interbranch asset balances are not assets for U.S. tax purposes and must be excluded from the "Total U.S. Assets of the U.S. Office."

(2) The average noneffectively connected assets booked by the U.S. office are included in the "Total U.S. Assets of

the U.S. Office" portion of the 10% rule formula.[4]

DISCUSSION

Interbranch transactions do not give rise to assets

A cardinal principle of U.S. tax law is that a taxpayer cannot make or lose money from entering into transactions with itself. See Eisner v. Macomber, 252 U.S. 189 (1919). Although this principle is not specifically mentioned in the regulations under Section 864 covering the determination of effectively connected income, the U.S. tax treatment of interbranch transactions has been addressed in other regulations. For the year(s) under examination, the version of § 1.882-5 then in force provided--"[A]ssets, liabilities, and interest expense amounts resulting from loan or credit transactions of any type between the separate offices or branches of the same foreign corporation are disregarded." § 1.882-5(a)(5) (1980). The identical rule has been provided in separate places in current § 1.882-5. § 1.882-5(b)(1)(iv); § 1.882-5(c)(2)(viii); and § 1.882-5(d)(2)(viii).

The exclusion of interbranch assets from eligibility for § 1.882-5 is relevant in determining that interest expense could not be allocated to income recorded from interbranch transactions. In this regard, the Service has held that the standard for determining whether an asset is includable in Step 1 of the § 1.882-5 interest expense allocation formula is by reference to whether the asset is effectively connected under the principles of section 864 and the regulations thereunder. See TAM 890004.[5] This symmetry with section 864

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[4] Since our previous advice concerned whether foreign source securities were eligible for inclusion as qualified residual class securities, it is our understanding that any increase in the percentage of income that is reclassified under the 10% rule formula will result in a reduction of U.S. effectively connected taxable income and complete avoidance of U.S. taxing jurisdiction on the allocated amount. In this regard, we are only aware of the taxpayer's attempt to allocate foreign source interest income to foreign source non-ECI classification. We are not aware of any losses with respect to the residual class securities that might also be subject to allocation.

[5] The TAM established the principle that the foreign banking taxpayer's establishment of a newly formed securities subsidiary was not an asset held for the conduct of the present needs of the U.S. trade or business under the Section 864 regulations then in force. Accordingly, the stock was held to be noneffectively

was recently confirmed by the Tax Court in Taiyo Hawaii Company, Ltd. v. Commissioner, filed June 25, 1997. At ¶ 58, the Court held "To be included in 'Step 1,' the asset must produce or be able to produce ECI with the conduct of a U.S. trade or business . . . section 864(c) governs the definition of whether an asset generates ECI." Accordingly, we conclude that the intended symmetry between sections 864 and 882(c) and the regulations thereunder would prohibit recognition of income or inclusion of interbranch balances as effectively connected asset balances for purposes of section 864.

Since interbranch balances cannot be effectively connected balances by symmetrical reference over to section 864, the question remains whether such balances could be noneffectively connected balances. We conclude they cannot. The standard for whether an asset security is effectively connected for a U.S. banking, financing or similar business is determined by reference to whether the U.S. branch actively and materially participates in the negotiation, solicitation or performance of other activities required to arrange the acquisition of the stock or security. §§ 1.864-4(c)(5)(iii) and 1.864-6(b)(2)(ii).

A necessary condition of whether an asset can be ECI is whether the U.S. office has conducted material activities in acquiring the asset for the corporation. Accordingly, a noneffectively connected asset might still be acquired solely by the non-material participation of the U.S. office in the conduct of the asset acquisition activities. However, the automatic exclusion of all interbranch asset balances from § 1.882-5 does not depend on the activities of the U.S. office. In this regard, § 1.882-5 does not provide or contemplate specific exclusions of assets that would otherwise be effectively connected under section 864. Accordingly, we conclude that the better symmetrical reading of § 1.882-5(a)(4) (and the current regulation) is that interbranch asset balances must be disregarded both for purposes of section 864 and 882.

Further explication of this principle has also been formally identified in regulations covering the accounting for income, gain or loss from notional principal contracts. In

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connected and excludible from the Step 1 assets of § 1.882-5. Even if the taxpayer could have factually shown that the subsidiary stock was effectively connected, the symmetrical reference to effectively connected status under Section 864 was confirmed as the standard of inquiry for determining the includibility of Step 1 assets for interest allocation purposes.

this regard, § 1.446-3(c)(1)(i) states in relevant part:

> [A]n agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer cannot enter into a contract with itself.

Total assets of a U.S. office include ECI and non-ECI assets

The 10 percent rule was adopted for purposes of allocating income that would, by formulary approach, be deemed not associated with the core activities of engaging in a banking, financing or similar business. The 10% threshold was adopted as an approximation to the comparative worldwide passive investment asset holdings of major U.S. money center banks. While we recognize that these institutions are taxed on a world wide basis, it was intended that the entire universe of asset holdings of the U.S. office be included for purposes of determining the appropriate percentage of securities that are classifiable as passive non-bank investments.

We conclude that a plain reading of the "attributable to" standard in conjunction with the 10% rule requirements shows that the regulation contemplates that noneffectively connected assets may be an ordinary component of a banking, financing or similar business's U.S. office activities. In this regard, there is a distinct difference between assets attributable to a U.S. office and the total assets of a U.S. office. Pursuant to § 1.864-4(c)(5)(ii), interest and dividends are effectively connected with the business of a U.S. office only if the assets giving rise to the interest and dividends are attributable to a U.S. office. However, the regulation specifically provides that assets may be a part of the U.S. books and records and not be considered attributable to the U.S. office. § 1.864-4(c)(5)(iii)(b) provides in relevant part that:

> [A] stock or security shall not be deemed attributable to a U.S. office merely because such office--
>
> (1) Collects or account for the dividends, interest, gain or loss from such stock or security,...
>
> (5) Holds such stock or security in the United States or records such stock or security on its books or records as having been acquired by such

office or for its account. [Emphasis Added].

We note that the language of subparagraph (5) is not included in the rule that enumerates the exceptions to "attributable to" status for foreign source securities. See § 1.864-6(b)(2)(ii)(a). However, subparagraph (5) was added to the "attributable to" exceptions for U.S. source securities when the regulation was amended in 1984. Prior to the 1984 amendment, a U.S. source stock or security was attributable to a U.S. office only if (1) the U.S. office actively participated in the activities required to arrange the acquisition of the stock or security and (2) the stock or security was held by or for the U.S. office and was recorded on its books or records. See T.D. 7958, 1984-1 C.B. 174, 175.

On reconsideration by the Service, the "booking rule" was considered potentially contrary to the legislative history of Section 864(c)(2). H.R. Rep. No. 1450, [1966-2 C.B. 967] 89th Cong., 2d Sess. 15 (1966); S. Rep. No. 17071, [1966-2 C.B. 1059] 89th Cong., 2d Sess. 19 (1966). It was also considered a potential loophole for avoiding U.S. tax with respect to "income generated solely by the efforts of the U.S. office in some circumstances." T.D. 7958, at 175. In addition, the drafters of the preamble to the amended regulation states that subparagraph (5) was added to the list of items considered factors of limited importance in the determination of active and material participation. This subparagraph was added "[t]o clarify that the office in which a stock or security is 'booked' is not controlling." Id. at 175. The override of the booking test was exemplified by the inclusion of an example based on the fact pattern applicable to foreign source securities in Rev. Rul. 75-523, 1975-1 C.B. 203. See § 1.864-4(c)(5)(vii) Example 5. No amendments were made to § 1.864-6(b)(2)(ii) concerning the treatment of foreign source securities, since the Rev. Rul. already interpreted the intended treatment for this class of instrument. The emphasis of the amendment was to make clear that the active and material participation test controlled whether stocks or securities could be attributed to a U.S. office not whether booking of securities in the U.S. would cause the securities to be attributable to the U.S. office. To this effect, the preamble to the amendment states:

> Whether the stock or security is "booked" in the U.S. office would no longer be a determinative factor, but would be one factor to be considered in determining if the U.S. office was an active participant. T.D. 7958, 1984-1 at 175...[T]he rationale for the active and material participation test is that a sufficient nexus must exist between

> the income and the activities of the U.S. office in order for the income to be effectively connected with a U.S. trade or business and to be taxed on a net basis. Id. at 176.

In accordance with the above discussion, we conclude that the term "total assets of [the U.S.] office" within the meaning of §1.864-4(c)(5)(ii) was intended to include asset securities that are both "attributable to" and non-attributable to the U.S. office.

Conclusion

Based on the above analysis we conclude that the residual securities allocation rule (also known as the 10 percent rule) in § 1.864-4(c)(5)(ii)(b)(3) requires that total third party assets of the U.S. branch does not include interbranch assets, but does include non-effectively connected assets booked on the U.S. office.

If there are any questions please contact Willard Yates at 202-622-3870.

Sincerely,

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Paul Epstein